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ABSTRACT

This chapter of "Principles of School Business Management" provides a basic understanding of the mechanics of the various taxes used to raise money for education, the extent to which these taxes are utilized, the way they interrelate, and the criteria that can be used when judging their relative advantages and disadvantages. The chapter opens with a discussion of the specialized concepts associated with the field of taxation, introducing new terminology and the technical considerations underlying current tax issues. The chapter then describes each major tax in some detail. These taxes include income taxes, sales taxes, local property taxes, and various minor taxes. Special attention is paid to property taxes because of their importance in school finance. The next part of the chapter reviews the criteria used for judging the value and suitability of taxes, including their relationship to ability to pay, their equality of impact, the benefits they provide, their costs, their stability as sources of revenue, and their effects on human behavior. Tax trends affecting the late 1980s are reviewed in the final portion of the chapter. A table presenting the relative tax effort in the 50 states is provided for selected years from 1967 through 1981. Thirty-four footnotes cite references or provide supplementary information. (PGD)

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# 4

# Taxation for Education

*Thomas H. Jones*

Effective school business administration requires a wide variety of knowledge and skills, including knowledge of taxation issues and practices.[1] At no time has this statement been more applicable than in the present decade. After forty years of nearly continuous growth, many schools today are confronting economic decline. Therefore, educational leaders and participants in the policy-making process must develop their expertise not only in spending money, but also in raising it.

The United States and all other developed countries rely on a variety of taxes to raise revenue. They have what is known as a "mixed" revenue system. Required then is some basic understanding of the mechanics of all taxes, the extent of their utilization and the way they relate with each other to form an entire revenue structure. Also important is some knowledge of criteria for judging the relative advantages and disadvantages of each tax.

This chapter begins with a discussion of the specialized concepts associated with the field of taxation. The discussion not only serves to introduce new terminology but also introduces the technical considerations underlying current tax issues and controversies. The second section describes each major tax in some detail. Property taxes receive special attention because they still make up the largest share of school revenue in most local school districts across the nation. The third section begins with a conceptual discussion of the principles of taxation; (what makes a tax "good" or "bad") and ends with an examination of taxes actually levied by the fifty states. Only with an understanding of the present tax system and criteria for evaluating alternatives is one in a good position to be an effective manager and an informed spokesperson for public education.

## Tax Fundamentals

The field of taxation has its share of specialized vocabulary which is used in virtually all discussions of taxation.[2] A tax has two elements: it is *compulsory*, and it is *unrequited*. People must pay taxes whether they want to or not because, as individuals, they have no choice in the matter. Moreover, payments ordinarily must be made without expectation of a commensurate benefit in return. Bachelors pay school taxes, for example, and pacifists help finance national defense.

That individuals cannot expect a benefit commensurate to the taxes they pay does not mean that no one benefits. It is hoped and indeed expected that the society as a whole will benefit in full measure from the aggregate amounts of money collected and spent. The point is that the individual taxpayer and the beneficiary are not necessarily the same person.



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The tax *base* is that which is taxed. Land, buildings and other improvements constitute the real property tax base, for example. The base also serves to measure taxpayers' *ability to pay* in relation to each tax. Ability to pay is the principle which distinguishes among various taxpayers in the amount of tax owed. As individual citizens we will believe that some measures of ability to pay, e.g., personal income, are better than other measures, e.g., cigarette smoking. Nevertheless, nearly all taxation is based on ability. The tax *levy* is the dollar amount collected. Levies may be spoken of in relation to one taxpayer or a whole jurisdiction.

The *impact* of a tax falls on that taxpayer or business organization that pays the bill initially. Sometimes, however, a tax may be transferred or *shifted* to others in the form of higher prices for products and services. When shifting occurs, the final *incidence* of the tax falls on a person or persons different from those who initially paid the bill. Taxes which cannot be shifted are sometimes called *direct* taxes; *indirect* taxes are those which can be shifted.

Analyzing the incidence of direct taxes is relatively simple, but determining who actually pays indirect taxes is more problematical. Unfortunately, empirical analyses of tax incidence are clouded by methodological problems and highly tentative assumptions. Economists frequently disagree among themselves as to who finally pays the tax in the last analysis. One point on which all experts agree, however, is that the final incidence of every tax falls on individuals. While so-called business or corporate taxes have an impact at the company level, the tax ultimately falls on owners, employees or consumers. Businesses do not pay taxes; people do.

Tax *capitalization* is a concept closely related to shifting. Assume that a new tax (or an increase in an existing tax) is enacted. If the incidence of the tax falls on the owners of an asset, it is highly likely that the asset itself will become less valuable to any prospective buyers. Because the tax has gone up, the asset itself becomes intrinsically less valuable. Ownership of the asset becomes less desirable due to the future stream of taxes the owner must pay.

Similarly, when there is a tax decrease such as the one that occurred for most homeowners when California passed its Proposition 13, property increases in value, since owners could expect their future stream of tax payments to be reduced.[3]

If the government's revenue from a particular tax changes faster than personal income, we say that the yield for that tax is income *elastic*. If changes in personal income and tax yield bear a one-to-one relationship, the tax has an *elasticity of unity*. When the yield of a particular tax changes more slowly than personal income, the term used is *inelastic*. For example, suppose personal income goes up five percent from one year to the next. If the yield goes up exactly five percent too, it has a unitary elasticity in that year. More than a five percent increase in yield and the tax would be elastic; less than five percent and the tax would be inelastic. Exactly the same terms would apply if personal income were to drop. The government's income from an elastic tax falls more sharply in periods of economic slump. In all cases, calculation of elasticity assumes a constant rate and base structure from one period to the next.

*Progressive* tax rates are set to tax upper income groups more heavily than lower. If a low income household pays, for example, ten percent of its income in a particular tax, a higher income household must pay some percentage in excess of ten for the tax to be progressive. *Proportional* taxes gather in the same proportion of

income across the income range. And *regressive* taxes require a higher percentage from the poor than the rich.

Keep in mind that these concepts deal with percentages not the number of dollars paid. Even for a highly regressive tax like the poll tax—a tax on voting, which fortunately is no longer used—it is probable that the rich paid more than the poor, since the latter were simply less likely to vote. (In fact, the tax itself was imposed to discourage poor people from voting.)

Progressivity deals with rate structure. Elasticity deals with actual yields. Although the terms are related, they are not the same thing, and bear no constant relationship to one another. For example, in the case of the poll tax it is probable that during the civil rights and anti-poverty movements of the 1950s and '60s, the number of people voting in some jurisdictions rose faster than personal income. Poll tax receipts would therefore also have risen faster. Under these assumptions the poll tax may have been highly regressive and elastic over the period!

*Marginality* is the concept of the last or incremental unit among similar units in a series. If a person owns ten shirts and is considering buying an eleventh, we may say that the eleventh is the marginal shirt. One historic assumption of welfare economics had been that the marginal unit is less valued psychologically than the preceding units.[4] People feel they "need" the eleventh shirt less than they need the tenth, the tenth less than the ninth and so on.

The concept of the diminishing marginal utility of income has been one rationale for progressive taxation. If the "last" few thousand dollars of income are less valued psychologically and materially than the "first" few thousand, then higher incomes may be taxed at higher marginal rates.

*Equity* is the concept of fairness or justice in dealing with others. Equity is subjective and as such it belongs more to the realm of philosophy than to economics. People will disagree as to what constitutes fairness, but nearly everyone would agree that all people should have a decent minimal living standard. Such a consensus militates strongly against regressive taxation on grounds of equity and promotes the existence of an income floor under which no one's living standard should fall. The "minimal living standard" consensus cannot, however, distinguish between proportional and progressive taxation on their merits. In view of these competing claims and conceptual frameworks, it seems certain that we cannot positively know which rate structure is best, although we can have strong subjective leanings. Keep in mind, however, that to determine the equity of any tax one must first make crucial assumptions about capitalization and shifting and about the desirability of progressive taxation. Since these matters are not thoroughly understood by economists and since there is a division of views based on subjective leanings, tax structures always will be a contentious issue in any democracy.

Public finance specialists are fond of likening taxes to workhorses and the government economy, with its spending services like education, to a wagon. In this analogy, there are three principal workhorses. These are income, sales and property. Other taxes frequently are called minor taxes because these three do most of the work.

It is more useful to discuss the major taxes according to type rather than by governmental jurisdiction (e.g., federal, state and local) for the latter tends to become repetitive. The basic description of each type of tax is the same for all governments, recognizing that there are differences in implementation which will be pointed out as necessary.

## The Income Tax

There are two types of income taxes: personal and corporate (or business) taxes. Both types require a definition of income in order to set the tax base. For definitional purposes the total amount of money that passes through the hands of an individual or business—accounting concepts like cash flow or gross income—are considered unsatisfactory measures. These sums do not measure well-being or taxpaying ability. Additionally, governments may wish to use their income tax laws to foster socially useful activities. For these reasons certain deductions, exemptions and credits are considered in setting the tax base.

For businesses the major portion of the deductible items includes that portion of total receipts which must be paid out in the conduct of business. In a sense the concept applies to individuals too. When individuals have extraordinary medical expenses, when they pay interest on debt or have casualty losses, these considerations, among others, are thought to reduce a person's economic well-being and thus should reduce taxable income. Other items such as a minimal amount of investment income or charitable contributions are deductible on the grounds that they improve the well-being of society or support certain activities which governments otherwise might have to undertake. Gross income less deductions and other adjustments represent adjusted gross income.

For individual taxpayers, governments also allow exemptions for dependents. In principle, these reduce taxable income by the amount all dependents require for a minimum living standard. The federal exemption is clearly too low according to this principle. However, many proposals for income tax reform at the federal level would raise the exemptions substantially.[5] Some states' income taxes do have exemptions which are closer to the minimum living standard.[6] Adjusted gross income minus exemptions yields taxable income.

Finally, there are credits, a concept that has been employed heavily in recent federal tax law changes. The rationale for credits is similar to those for deductions and exemptions. But credits are reductions from the tax which would otherwise be payable, resulting in the same dollar saving to all qualified taxpayers regardless of income. Deductions on the other hand result in greater dollar savings for the higher income group, if the rate structure is progressive.[7]

The personal income tax is the only major tax which has been clearly progressive over the years across the full income range, and this feature accounts for much of its popularity and its controversy. About four fifths of the states have fully operative income taxes for individuals, and several of the others levy taxes on income derived from specific sources, such as stock dividends and capital gains. Nearly all states have some degree of progression in their rate structure with the highest rates exceeding ten percent for taxpayers in some states. For an average family of four, state income taxes amounted to just over two percent of personal income in 1980. However there are wide variations from state to state.

The federal rate structure is, of course, steeply progressive, and the percentages are much more substantial.

Local income taxes usually have low, uniform rates, yet there are significant exceptions to this generality.

Federal corporate income taxes have been at roughly the fourty-five percent

level in recent years for all but the smallest enterprises. The latter pay less, so there is some slight progression. Deductions and allowances have reduced the corporate tax burden substantially in recent years. Nearly all states, but very few localities, levy corporate income taxes.[8]

Table 4:1 shows the growth in income tax receipts over the last quarter century. Reliance has been heaviest at the federal level because this is the only level of government which can impose high, steeply progressive rates. The extent of the federal government's jurisdiction makes its high taxes virtually impossible to avoid, while people can always move away if a state or community's taxes climb too high. Despite the limitation on rates, the federal government hardly can be said to have preempted the income tax as its own source of revenue. States and localities do rely heavily on both personal and corporate income taxes. This reliance has grown over time as laggard states have finally adopted the tax and other states have raised their rates.

TABLE 4:1 Income Tax Collections from Individuals and Corporations, 1957-1983
(in millions of dollars)

| | Level of Government | | |
|---|---|---|---|
| Year | Federal | State | Local |
| 1957 | $ 57,787 | $2,547 | $ 191 |
| 1967 | 95,497 | 7,136 | 916 |
| 1977 | 211,617 | 34,666 | 3,754 |
| 1983 (est.) | 326,000 | 63,000 | 6,000 |

est. = estimated

Sources: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1982-83 Edition* (Washington: ACIR, 1984), 36.

Shifting is not possible in the case of personal income tax. The impact and incidence necessarily are the same for all individuals. Shifting does occur in corporate income taxation, although to whom is still an open question. Whether corporations pass the tax on to consumers in the form of higher prices or whether the owners pay the tax in some form of reduced profits depends on the realities of the particular market and economic viewpoints. If owners pay the corporate income tax it would be progressive at least for the very highest levels of income, since ownership of corporations is heavily concentrated among the upper income groups. If consumers pay the corporate income tax, it would be regressive, since lower income groups spend a larger share of other income and do less saving.[9]

The argumentation here parallels the discussion of property tax incidence to be discussed in more detail later. Contemporary economic theory links the real property tax on businesses with the corporation income tax for purposes of incidence analysis.

The two taxes are quite different in some respects, of course. The corporate income tax is a state and national tax while the property tax is local. The bases are different. Corporate income taxes are tied directly to profits, while property taxes remain relatively static in good years and in bad. Nevertheless, the crucial principle of shifting still applies. The belief that the property tax is regressive while the corporate income tax is progressive (or vice versa) represents a view that is increasingly discredited among economists.[10] To advocate reductions in one tax and increases in the other may make little sense if help for the low income groups is the objective.

By definition a progressive personal income tax is elastic; a proportional tax has an elasticity of unity. Elasticity coefficients for corporate income taxation are also greater than one.

## Sales Tax

Sales taxes also may be divided into two broad categories, general and selective (or excise). The first term applies when all, or nearly all, products and services are included in the base. Selective taxes are levied on a few specific and related products, e.g., alcohol, petroleum products, customs duties. In the United States most sales taxes are collected at the retail level. This is not the case for some of the selective sales taxes, however, and need not be the case for general sales taxes either. Most countries with national sales taxes impose them at the producer, distributor or wholesaler level or all three. The much discussed value-added tax, which is really just one form of sales tax, is imposed at each stage of the production process rather than at retail level.[11] Alternate forms of sales taxes need not overly concern us here. Americans are used to the tax at the retail level, and it will doubtless continue.

General sales taxes have been left to state and, occasionally, local government use while excise taxes are levied at all three governmental levels. Table 4:2 shows the twenty-five year growth in sales tax receipts since 1950.

TABLE 4:2 Sales Gross Receipts and Customs Tax Collections, 1957-1983, (in millions of dollars)

| Year | Totals (Federal, State & Local) |
|---|---|
| 1957 | $ 20,594 |
| 1967 | 36,336 |
| 1977 | 83,821 |
| 1983 (est.) | 142,000 |

est. = estimated

Sources: Advisory Commission on Intergovernmental Relations. *Significant Features of Fiscal Federalism, 1982-83 Edition* (Washington: ACIR, 1984), 36.

Federal tax revenues have grown just 400 percent while state revenues have grown by over 1400 percent. Local receipts have grown even faster but from a

much lower base. Rather than the federal government preempting the income tax as a revenue source, it might be closer to the mark to conclude that states have nearly preempted the sales tax. Another striking feature of the table is the decline in percentage of all sales taxes that are excises. These taxes, with their relatively narrow base, have simply not been able to keep up with government spending requirements.

By 1984 all states except New Hampshire, Delaware, Montana, Oregon and Nevada had a general sales tax. Over half of the states permit some sales taxation at the local level. While their direct use for public education may be limited to only a few jurisdictions, local sales taxes are important because they free up the property tax for school use.

Food and medicine are exempt from most states' general sales taxes. Some states also exempt clothing, drugs or other necessities. Exemptions such as these probably make the tax roughly proportional for people in the middle income levels. For poor people who spend most of their income on exempted items the tax may be slightly progressive. At the highest income levels, the tax may be somewhat regressive since wealthy people tend to save and invest a larger proportion of other income.

All states impose a variety of selective sales or excise taxes. The levy on gasoline is by far the largest revenue producer among the excises. Most of the selective sales taxes are regressive, and this, too, partly explains governments' decreased reliance on excise taxation. Excise taxes are sometimes collected by producers, but the usual assumption of sales taxation is that consumers do pay in the end. Incidence analysis has not received nearly so much attention as it has in connection with respect to corporate income and property taxation.

By raising the price of consumables, the sales tax discourages consumption. Everything else but consumption becomes relatively cheaper by the amount of the tax. The most important exempted item is saving. Sales taxes, therefore, encourage saving because the more that is saved the less that is spent in consumption and the less tax that is paid. Of course, many factors influence one's decision to save, and the sales tax is a relatively minor consideration. Still it does matter. People do respond to taxes by changing their behavior. Most of the time these behavioral changes may be so slight or so gradual that they go largely unnoticed.

The income elasticity of yield for general sales taxes is nearly unitary, or 1.0 in most years. Many of the excises are inelastic, since consumption of the taxed item tends to remain about the same regardless of changes in personal income.

## Local Property Tax

Property taxation is the third major workhorse in the tax stable.[12] From its beginning in New England, American public education has been financed largely through this revenue source. Although most states rely on the tax less than they did in the past, it still provides about forty percent of all public school support in the United States.[13]

The property tax holds a unique position in the American public financial system. It is the only major tax which is highly suitable for local governments, including school districts. Yet its primarily local character makes generalizations about

the description and operation of the tax more tentative and open to exceptions. For purposes of analysis economists view it as a bundle of different taxes with different rate structures applying to different kinds of property. For example, the property tax on single-family or owner-occupied housing, may be quite different from the property tax on rental housing, farm, stores and large industrial complexes. What is more important, the fact that commercial property owners may be able to pass along some or all of the tax to consumers, complicates the analysis of property tax.

The local property tax can be distinguished from other taxes in several ways. First, the tax has a competitive aspect. Different local jurisdictions are in a sense competing with each other to provide the best possible public services, including education, at the lowest possible cost. Second, the tax is highly visible and is usually paid *directly* by the property owners. The tax is not withheld from salary, like income taxes, included with the costs of purchase, like the retail sales tax or paid indirectly, like many taxes on business.

Of the totals shown in Table 4:3, only about five percent represent state property tax receipts and ninety-five percent are local receipts. The federal government levies no property tax.

Table 4:3 Property Tax Receipts of State and Local Governments, 1957-1983, (amounts in millions of dollars)

| Year | Amount |
|---|---|
| 1957 | 512,864 |
| 1967 | 26,047 |
| 1977 | 62,527 |
| 1983 (est.) | 90,000 |

Taxable property is defined differently by different states, although by definition it must fall into one of three broad categories: 1) tangible real property, 2) tangible personal property and 3) intangible personal property. While most states do have some form of "personal property tax," they vary widely in their nature and structure.

Tangible personal property typically includes items like automobiles and boats. Since most of these items are licensed, tax evasion is more difficult than with unlicensed types of personal property such as antiques, gem stones and fur coats. This topic receives greater treatment later in the chapter. Intangible personal property includes stocks, bank accounts and other assets representative of wealth but not intrinsically valuable. Of all types of property, intangibles are the least heavily taxed since concealment and transportation are relatively easy.

By far real property is the most important property tax category. Real property is defined as land, buildings and other improvements, e.g., in-ground swimming pools and drive-ways. In some states heavy machinery and fixed equipment found in business and industry are included in this category.

Valuing real estate according to its selling price is the most common way of setting taxable property values in the United States, although two other methods are sometimes used. Where property values are set according to sales price, the sales must be legitimate transactions. Sales of property between two business partners or two members of the same family must be scrutinized carefully. The selling

price should represent the maximum amount that the seller could reasonably expect to receive and the minimum amount the buyer could reasonably expect to pay. This amount represents the "true market value" of that parcel.

Since most properties are sold infrequently, market values of property must be estimated. Localities may employ outside organizations, or use local civil servants, to value or "assess" properties for tax purposes. Assessment is a highly technical task that should be conducted by trained professionals.

There are two other approaches to assessing property for tax purposes. While not as widely used as the selling price approach, they are common enough to deserve special mention. First, property can be taxed on its income earning capacity or rental value—the amount of money such property would bring to its owner in a typical recent year or longer period of time. The tax then becomes some portion of the real or hypothetically calculated rent. The second approach is to base the tax assessment on the original cost or replacement cost of the property less depreciation. This accountant's method is appropriate for such properties as steel mills or electric power plants that are rarely, if ever, sold or rented.

These three valuing methods, selling price, rental and replacement cost, can generate very different revenue results. The following discussion will assume a market value approach, since it is the most common in the United States. The concept used in this discussion, however, can be applied to any of the three valuation methods.

By custom most localities assess their properties at some percentage of full market value. For example, if the "assessment ratio" is set at fifty percent, then a property with a market value of $70,000 should be assessed at $35,000. Another property which would sell for $500,000 on the open market should be assessed at $250,000 and so on.

The full details of fractional assessment need not be discussed here. Suffice it to say that the practice has a political foundation. Fractional assessment makes all properties appear to be worth less than they really are and makes property tax rates appear higher than they really are, when taxes are expressed as a percentage of assessed value.

At tax time everyone likes to look poor and overburdened, but tax experts tend to be opposed to fractional assessment. It adds to taxpayer confusion and makes sound administration of the tax more difficult.

In the simplest case, all property of whatever type is taxed at the same fraction of market value. However, the traditional American custom of assessing property at some percentage or fraction of market value has given rise to various property tax classification movements. Where successful, these movements have produced state laws permitting or requiring localities to tax some classes of property at a larger fraction than other types. For example, all residential property might be assessed at one half of (the assessor's estimate of) market value while all commercial and industrial property is taxed at two thirds. Mines, farms and undeveloped acreage are examples of property that are given special classifications in various states or localities. In some states, the tax advantage may extend even to the elimination of the tax entirely on certain types of property, thus making property classification schemes similar to tax exemptions, discussed later. By one recent count, nine states and the District of Columbia had comprehensive property tax classification schemes.[14] In addition to these comprehensive plans, states have specific assessment ratios for assessment of farmland.[15]

In some instances property owners are granted tax exemptions if their property is given over to special uses. Land used for religious and charitable purposes, for example, is always exempt from property taxation. The "circuit-breaker" laws in many states provide tax rebates to low income and elderly homeowners (and in some states, tenants) if they pay more than a specified percentage of their income in tax. Some states allow local jurisdictions to promote the establishment of new business and industry through various property tax reduction or elimination plans. Homestead exemptions reduce the tax paid on houses by making the first few thousand dollars of house value exempt from tax. In all these cases state statutes regulate the types of tax forgiveness that properties and their owners receive.

Since tax classification and forgiveness laws vary so greatly from state to state, further discussion of specific provisions would not be useful. It must be remembered, however, that provisions favoring certain classes of property and owners put extra burdens on other classes. Often, those not favored must be taxed more heavily than would otherwise be necessary in order to raise needed revenue.

As evidence from the above discussion, the true market value of properties in any local jurisdiction will be much higher than the assessed values due to fractional assessment, classification and/or exemptions. It is the assessed value, however, which forms the base to support schools and other local public services. The assessed value of all taxable parcels of property within a school district is totaled to obtain the dollar value of that jurisdiction's tax base.

### The School's Portion of Tax Revenues

Several factors influence local school boards and administrators as they strive to determine their amount of local property tax revenues in any given year. The first is the need of other local governmental agencies for non-school services. A portion of highway, park, police, recreation and other service costs usually must be borne by the property tax base. Table 4:4 lists the average percentage of local revenues apportioned to major public services. Schools are generally the most costly local service, requiring more than forty percent of all local revenues. But the averages are misleading in certain jurisdictions. Because of heavy non-school needs, large cities often spend a much smaller percentage of their local revenues on the public schools.

Table 4:4 State Limitations on Local Government Taxing and Spending Powers, The Growth in the '70s

| Year | Exemptions, base and rate limits | Number of full disclosure laws | States with property tax levy limits | States with expenditure lids |
|---|---|---|---|---|
| 1970 | 40 | 0 | 3 | 1 |
| 1979 | 46 | 10 | 20 | 8 |

*Source:* Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism 1979-80 Edition*, (Washington: ACIR, 1980), 185.

Other factors affecting the school district's portion of the property tax base are legal constraints, such as: 1) fiscal dependence, 2) tax rate, tax base and tax levy limitations 3) per pupil spending and budget limitations and 4) full disclosure provisions.

*1. School district fiscal dependence.* School districts are sometimes prohibited by state law from setting their own taxes and budgets directly. In this event the districts must obtain approval from other local governmental bodies. These other governmental bodies have the duty of reviewing, discussing and finally approving the school system's tax and/or budget. Typically their role is confined by law to control over the total magnitude of the budget. Within broad state guidelines, school boards supposedly are free to allocate funds as they see fit. Informally, however, these non-education bodies have been known to make approval of the full budget contingent upon the items within it.

*2. Local tax rate base and levy limitations.* States may, by statute, limit the tax rate that school districts can impose. Limitations are expressed as some percentage of assessed value. Particularly where assessed values have risen rapidly, states may impose limitations on the base. California's Proposition 13, for example, limited assessment increases to a fixed percentage per year, except in the event that the parcel was actually sold.

Levy limitations apply to the amount of total revenue increase without direct reference to the base or rate. Annual increases may be limited to a fixed percentage of last year's budget or may be tied to some other index like the rise in personal income.

Tax limitations may be *absolute* (under no circumstances may localities exceed the limitation) or *provisional* (the local electorate or state authority may permit the limitation to be exceeded). Limitations may apply to the entire school budget or to specific portions, e.g., the portions used to finance school construction.

*3. Per pupil spending and budget limitations.* Restrictions may be imposed on the growth in school expenditure either by limiting the total budget or by limiting the annual growth in spending per pupil. Some jurisdictions must submit their budgets to a vote of the people. In other localities school budgets are restricted by law to some arbitrary level of growth, for example, seven percent per pupil per year. Again, states can show varying degrees of flexibility in applying these restrictions.

*4. Full disclosure.* This is a somewhat more flexible application of the property tax restraint concept. Flexibility lies in the provision that localities may raise school (and other) taxes if they first make paid announcements and hold public hearings on the proposal. In other words, with full disclosure a revenue increase is possible. Rates may not be increased, and if the tax base goes up, rates are automatically rolled back to offset it.

States may, of course, impose more than one of these types of restraints. Within any state, restraints may affect some local governments but not all. Table 4:5 indicates the wide-spread use of these mechanisms and their growth in the last decade.

Tax and expenditure controls should be viewed as different means of accomplishing the same objective. Limitations in tax rates or bases automatically impose limits on expenditure and vice versa.

**Table 4:5 Direct General Expenditures of Local Governments, By Function 1976-77[a]**

| Function | Amount (in millions of dollars) | | Percent of Total[b] |
|---|---|---|---|
| Education | $75,707 | | 44% |
| Schools (70,895) | | (41) | |
| Others (5,993) | | (3) | |
| Social Services | 23,721 | | 14 |
| Transportation | 11,152 | | 7 |
| Public Safety | 15,349 | | 9 |
| Environment | 14,014 | | 8 |
| Housing | 3,210 | | 2 |
| Other | 27,785 | | 16 |

a/ Expenditures include intergovernmental transfers.

b/Percentages add to 96 due to rounding errors.

*Sources:* U.S. Department of Commerce, Bureau of the Census, *Compendium of Government Finances, 1977 Census of Governments, Vol. 4(5)*. (Washington, D.C.: GPO, 1979),32.

## Setting the Rate

The school tax rate can be set by formula, once a district's local property tax revenue requirements are determined. The formula for setting the school tax rate is:

$$STR = \frac{LREV}{LAV}$$

where, STR = the school property tax rate in a given district in the particular year; LREV = local property tax revenue needed to operate the schools in the particular year; and LAV = the local assessed valuation in that district in that same year.

For example, if $3 million in local property tax revenues were needed to run the schools in a particular year, and the district's total assessed valuation were $100 million, then the school tax rate would be $3 million divided by $100 million or three percent.

Other terms may substitute for percentage figures in common parlance. A tax of three percent may be called 30 mills, $3 per hundred or $30 per thousand of assessed valuation. One mill equals 1/10 of a cent or $.001.

The school tax rate multiplied by the assessed value of any single parcel represents the amount of school tax the owner of that parcel must pay in a year. Some jurisdictions require a single lump sum payment. Other localities spread out the payments. Many commercial and residential property owners pay one twelfth of their property tax each month, along with their mortgage.

## Minor Taxes and Other Income Sources

Other revenue instruments include taxes on transfers of wealth at the owner's death. *Death taxes* take two forms, estate taxes imposed on the entire amount of an estate and wealth and inheritance taxes imposed on the share to each heir. The federal tax applies to estates and is so structured that the states may pick up a share of it at no additional cost to the estate itself. Also, states may impose an additional tax of their own, either on the estate or the inheritance. The latter type is the most common at the state level. Recently, death taxes have raised an average of $8 million per year.[16]

*Fees* and *licenses* are another source of governmental revenue, but they are not taxes in the ordinary meaning of the term. They are linked to a distinct governmental service that is ordinarily expected in return for the payment. State motor vehicle and driver's licenses are the largest revenue raisers in the fee and license category. Public schools too may impose fees occasionally, but these generally do not significantly impact the financing of education.

### Intergovernmental Aid

Intergovernmental aid is a large and growing source of revenue for state and local governments. Only a fraction of all intergovernmental aid goes directly to schools. Nevertheless, indirectly it assists schools by freeing up funds previously allocated to other public services. As Table 4:6 indicates, lower levels of government have become increasingly dependent on higher ones, although this trend may be reversing at the present time. Intergovernmental aid allows states' local expenditures to greatly exceed their revenues, and public schools certainly have not been immune from this trend.

Table 4:6 Intergovernmental Revenue as a Percentage of General Revenue From Own Sources[a]

| Year | Federal aid to state | Federal and state aid to localities |
|---|---|---|
| 1960 | 31% | 44% |
| 1970 | 33 | 57 |
| 1980 | 38 | 79 |

a/ excluding duplicative intergovernmental transfers

*Sources:* Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1980-81 Edition* (Washington: Advisory Commission on Intergovernmental Relations), 59.

It is clear from Table 4:7 that there have been long term tax trends leading to a gradual de-emphasis of some taxes and increasing reliance on others. Income taxes have become the most predominant form of taxation, with the shares of all other revenue sources on the decline. This is indeed a reflection of the popular belief that the income is the fairest tax. But questions about the equity of deductions, exemptions and definitions of taxable income remain with us, suggesting that there are limits to the additional income that governments can expect to derive from income tax.

**Table 4:7 Tax Trends, 1950-1980**

| | Federal, State and Local Taxes expressed as a percentage of total revenues: | | | |
|---|---|---|---|---|
| **Year** | **Personal Income** | **Sales and Excise** | **Real Property** | **Other[a]** |
| 1950 | 32% | 25% | 14% | 29% |
| 1960 | 38 | 21 | 15 | 26 |
| 1970 | 43 | 21 | 15 | 21 |
| 1980 | 50 | 19 | 12 | 19 |

a/ among others are corporate income, death and gift, motor vehicle and operators licenses, severance, documents, stock transfer

*Sources:* *Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, 1980-81 Edition* (Washington: ACIR, 1981), pp. 40-41.

Bureau of the Census, *State Government Tax Collection in 1980.* (Washington: U.S. Government Printing Office, 1980), p. 5.

## Conceptual Criteria for Evaluating Taxes

Before discussing the rationale for a mixed or multi-source revenue system such as we have in the United States and the merits of each of the taxes, it is important to consider the irony that exists within most tax schemes. On one hand, a government endeavors to promote social justice and material well-being through services and programs paid for by taxes. On the other hand, mankind has yet to find the "perfect" tax. That is, every tax has aspects of injustice, undue economic burden, or both. Taxes, in a sense, undermine those very objectives which governments set out to achieve. Of course a society with no government is impossible. What we must hope and expect is that the positive results of governmental services improve the human condition more than taxes retard it. The tax system as a whole must mitigate the negative effects of each tax while raising sufficient revenue. The primary means for accomplishing this in the United States has been to levy a variety of taxes.

Over the last three centuries economists have devised several criteria for weighing the merits of particular taxes. Every tax satisfies some of these criteria, but no tax satisfies all of them. Having many taxes not only assures that all the criteria will be met and violated simultaneously, but also minimizes the social injustice and economic burdens associated with any one tax.

### Ability to Pay and Equal Treatment

There is general agreement that in order to make taxes as equitable as possible they should be based on the principle of ability to pay. In the United States, nearly all taxes are levied on this basis. This simply means that taxes are collected from individuals with no fixed expectation of a personal benefit in return. In a democracy, ability to pay is the collective social judgment of the voters.

Equal treatment of people in the same circumstances and treatment of people in different circumstances in accordance with relevant differences are different ways for saying almost the same thing. People in identical situations with respect to a particular tax should pay the same amount. People in different situations should pay different amounts, but the payment differential should be reasonably related to their differing situations. It would be unfair, for example, for one family which had only a slightly larger income than another to pay a much bigger income tax. Equal treatment of equals is sometimes called "horizontal equity." Reasonably different tax treatment of people in different situations is referred to as "vertical equity," or sometimes "unequal treatment of unequals."

**Benefits Received**

*Benefits received* is still another principle used occasionally. According to this principle, taxpayers can expect a return benefit that is roughly commensurate with their tax payment. Therefore, taxes levied on this principle may be termed compulsory but requited.

The only important example of a tax based on benefits received is the excise on motor fuels, if all the revenues are dedicated for repair and expansion of the highway system. The more that motorists use the roads the more gasoline they use and the more tax they pay. In this case there is rough parity between the tax paid and the benefits received. In fact, historically gasoline tax revenues have supported a variety of governmental operations, not just highways, thus placing the gasoline tax back into the traditional "ability to pay" category.

Taxes based on benefits received are very nearly like governmental fees or user charges already discussed in the previous section of this chapter. The difference is, perhaps, in the degree of "voluntarism" on the part of the payee. For example, toll roads fees are true user charges because there is usually another parallel highway that does not charge a toll. People do not have to use toll roads but everyone is compelled to pay gasoline tax either directly at the gas pump or indirectly in the form of high prices for the merchandise they buy. In any case, taxes are, in the overwhelming number of cases, based on ability to pay. The gasoline tax may be called the exception that proves the rule.

*Regressivity v. Progressivity*. The three most prevalent measures of ability to pay are income, sales (consumption) and property (wealth). Of these three, income is possibly the most generally accepted measure of personal well-being. Nearly all taxes, whatever the base, are paid out of current income, and when we say that people are "poor" or "rich" we generally mean to imply something about their personal income. The tax on personal income is one of the very few which lends itself to a "progressive" rate structure. Progressive taxes allow society to redistribute material well-being among its members by taxing at different rates. Regressive taxes, on the other hand, tax everyone at the same rate. Popular analysis of tax structures as a whole measure incidence by income class. Under a wide variety of assumptions about tax incidence, income taxes are progressive; sales taxes are regressive, as reflected in Table 4:8.

The regressivity of the property tax is not so clear, with recent economic analyses. The argument for regressivity begins with the irrefutable observation that low income households usually spend all their income on consumables, while successively higher income families are likely to invest successively higher proportions

of their income into business, stocks, savings accounts, apartment buildings and the like. These investments constitute a kind of property.

Rather than incur the tax burden themselves, however, property owners, who are relatively wealthy, often are able to pass on the bulk of their taxes to consumers of their products and services. For instance, landlords shift the tax to tenants through increased rents, and businessmen include the costs of the taxes they pay in the price of their products. Since low income groups spend all or nearly all their income on consumables, while higher income groups save a much larger share, the property tax can be considered regressive. With owner-occupied houses, on the other hand, the owner is the consumer and the tax cannot be shifted.

Two contemporary economic views directly refute the regressive assumption about property taxes.[17] According to the first, most of the tax cannot be transferred to consumers. Instead the burden is borne by owners of property—landlords, businessmen, corporate stockholders and the like. Since property ownership is concentrated in the higher income classes, the no transfer assumptions would make the tax progressive.

A second revisionist view recognizes that some transfer may take place, but claims that previous methods of calculating tax burdens are based on incorrect assumptions. New calculations based on different assumptions, therefore, indicate that even if consumers do pay most of the property taxes, middle and upper income groups pay a greater percentage of their income in tax than was previously believed. The new calculations, however, are based on assumptions that are themselves highly questionable.

All sides recognize the difficulty of making statewide or national generalizations about the progressivity or regressivity of the tax. Farms, factories and houses, for example, are all taxable. But economists treat each category of property differently for purposes of analysis. Within the housing category alone, opinions differ about the tax treatment of renter versus owner-occupied housing, older houses versus newer ones and expensive houses versus cheaper ones. Finally, the variation in rates from jurisdiction to jurisdiction makes analysis more difficult. Economists may treat the first few mills of property tax levied in all jurisdictions in one way, but the tax rate differentials above the minimum level may be treated quite differently.

It is impossible here to discuss the full variety of views on this question. It follows that under either set of revisionist assumptions, the tax falls most heavily on the higher income groups. If the traditional view is accepted, the tax burden falls more heavily on low income groups.

Educational leaders are more interested in an answer to the progressive/regressive question than they are in the methods and assumptions used in studying it. If the tax is regressive, most people would agree that other methods of school financing would be more equitable. But if the tax is progressive, criticism of the local school property tax on the basis of equity would be less warranted, although other equity problems remain.

The uncertainty of tax experts concerning whether property taxes are regressive or progressive is significant in itself. School business and economic specialists are

**Table 4:8 Distribution of Tax Burdens by Income Classes, 1966[a]**
**(Income classes in thousands of dollars; tax rates in percent)**

| Adjusted family income | Individual income tax | Corporation income tax | Property tax | Sales and excise taxes | Payroll taxes | Personal property and motor vehicle taxes | Total taxes |
|---|---|---|---|---|---|---|---|
| | | | Variant 1c | | | | |
| 0-3 | 1.4 | 2.1 | 2.5 | 9.4 | 2.9 | 0.4 | 18.7 |
| 3-5 | 3.1 | 2.2 | 2.7 | 7.4 | 4.6 | 0.4 | 20.4 |
| 5-10 | 5.8 | 1.8 | 2.0 | 6.5 | 6.1 | 0.4 | 22.6 |
| 10-15 | 7.6 | 1.6 | 1.7 | 5.8 | 5.8 | 0.3 | 22.8 |
| 15-20 | 8.7 | 2.0 | 2.0 | 5.2 | 5.0 | 0.3 | 23.2 |
| 20-25 | 9.2 | 3.0 | 2.6 | 4.6 | 4.3 | 0.2 | 24.0 |
| 25-30 | 9.3 | 4.6 | 3.7 | 4.0 | 3.3 | 0.2 | 25.1 |
| 30-50 | 10.4 | 5.8 | 4.5 | 3.4 | 2.2 | 0.1 | 26.4 |
| 50-100 | 13.4 | 8.8 | 6.2 | 2.4 | 0.7 | 0.1 | 31.5 |
| 100-500 | 15.3 | 16.5 | 8.2 | 1.5 | 0.3 | 0.1 | 41.8 |
| 500-1,000 | 14.1 | 23.0 | 9.6 | 1.1 | 0.1 | 0.2 | 48.0 |
| 1,000 and over | 12.4 | 25.7 | 10.1 | 1.0 | | 0.1 | 49.3 |
| All classes | 8.5 | 3.9 | 3.0 | 5.1 | 4.4 | 0.3 | 25.2 |

a/ Under Variant 1c, the corporation income tax and the property tax on improvements are included in adjusted family incomes of stockholders and property income recipients; under Variant 3b, (next page) half the corporation income tax and the entire property tax on improvements are regarded as indirect taxes and are distributed among all family units in calculating adjusted family income.

Table 4:8 (Continued)

| Adjusted family income | Individual income tax | Corporation income tax | Property tax | Sales and excise taxes | Payroll taxes | Personal property and motor vehicle taxes | Total taxes |
|---|---|---|---|---|---|---|---|
| | | | Variant 3b | | | | |
| 0-3 | 1.2 | 6.1 | 6.5 | 9.2 | 4.6 | 0.4 | 28.1 |
| 3-5 | 2.8 | 5.3 | 4.8 | 7.1 | 4.9 | 0.4 | 25.3 |
| 5-10 | 5.5 | 4.3 | 3.6 | 6.4 | 5.7 | 0.3 | 25.9 |
| 10-15 | 7.2 | 3.8 | 3.2 | 5.6 | 5.3 | 0.3 | 25.5 |
| 15-20 | 8.2 | 3.8 | 3.2 | 5.1 | 4.7 | 0.3 | 25.3 |
| 20-25 | 9.1 | 4.0 | 3.1 | 4.6 | 4.1 | 0.2 | 25.1 |
| 25-30 | 9.1 | 4.3 | 3.1 | 4.0 | 3.6 | 0.2 | 24.3 |
| 30-50 | 10.5 | 4.7 | 3.0 | 3.5 | 2.6 | 0.2 | 24.4 |
| 50-100 | 14.1 | 5.6 | 2.8 | 2.4 | 1.3 | 0.1 | 26.4 |
| 100-500 | 18.0 | 7.4 | 2.4 | 1.7 | 0.7 | 0.1 | 30.3 |
| 500-1,000 | 17.7 | 9.0 | 1.7 | 1.4 | 0.4 | 0.2 | 30.3 |
| 1,000 and over | 16.6 | 9.8 | 0.8 | 1.3 | 0.3 | 0.2 | 29.0 |
| All classes | 8.4 | 4.4 | 3.4 | 5.0 | 4.4 | 0.3 | 25.9 |

*Source:* J. A. Pechman and B. A. Okner, *Who Bears the Tax Burden?* (Washington: Brookings) 1974, 59.

no longer justified in asserting as they once did that the property tax is definitely a regressive tax, thus increasing the respectability of the property tax among experts, while popular opposition to it has remained strong.

### Taxes on Wealth

Another group of taxes can be called generally, "taxes on wealth"—that is, anything that can be sold to produce income in the future. This category includes the tax on real and personal property discussed previously, business assets not taxed as real property, stocks, bonds and other intangibles. These taxes together constitute a major source of governmental revenue, but one with new, associated inequities.

One criticism of taxes on wealth, including the real property tax, is that the rates and bases vary among different jurisdictions. Local school revenues frequently are a function of the wealth of the community in which the school system is located.[18] One possible solution, discussed elsewhere, would be a uniform state-wide property tax.[19]

An even clearer inequity is that different forms of wealth are taxed differently by the same local government. Personal property often escapes taxation entirely even though real property may be taxed heavily in that same jurisdiction. With the personal property category, licensed or registered assets such as stocks, bonds, cars or pleasure boats are more likely to be taxed than unlicensed assets. It is clear that those with the same "ability to pay," pay different amounts depending where and in what form they hold their property. But even within the same category of property, valuation for tax purposes usually is difficult. These considerations mean that taxation of wealth consistently violates equal treatment criteria.

On the other hand, wealth taxes have many positive features. They are among the most redistributive of all taxes since wealth is highly concentrated. The principle of wealth taxation is widely accepted; it is a fair measure of ability to pay, and because real estate is not moveable, this is the one form of taxation entirely suitable for all three levels of government, including local government.

The serious objection to the income tax on equity grounds lies not with its theory but with its practical operation. Suffice it to say that tax fairness or unfairness, like beauty, is in the mind of the beholder. To the extent that citizens and voters believe the income tax as it presently operates is unfair, it is. Loopholes undoubtedly help explain people's negative perceptions. As a result of these criticisms, the tax must certainly be considered as a less valid measure of ability to pay.[20]

Of the three major tax categories, sales taxes would seem to have the weakest claim on ability to pay grounds. Consumption is not as broad a measure of economic well-being as either wealth or income. Funds which are not spent for consumption, that is, savings, avoid the tax entirely. But on the equal treatment criterion, sales taxation fares very well indeed. Consumption is a much less ambiguous concept than income and much less elusive than wealth. Everyone who makes the same purchases pays the same amount.

Since most excise taxes are largely unrelated to either wealth or income, they are considered to be particularly poor measures of ability to pay. Narrowly based taxes on specific commodities have, nevertheless, been a mainstay of governmental revenue systems for centuries, before equity concepts were developed to the extent they have been today. Still, moderate excises seem to be widely accepted. What

they lack in contemporary justification, excise taxes make up for in historical legitimacy.

Overall consumption is a much better measure of economic well-being. Therefore, a general sales tax does have a stronger claim of legitimacy than excises on grounds of ability to pay. Comparing different persons with the same income, sales taxes would seem to be fair. Horizontal equity is not much of a problem. The problem is vertical equity. The retail sales tax, as it presently operates, is not distinctly progressive throughout the income range since the well-to-do save a larger proportion of their income and spend a smaller share. Where a degree of progression can be built into the concept of sales taxation, society would at least have that option. And sales taxation would fare better on the basis of ability to pay.

## Other Considerations in Evaluating and Selecting Taxes

Income, wealth and consumption are, of course, overlapping measures, but each is sufficiently different that a tax on any one of them affects individuals differently. People will argue about which measure is best, but on consideration of the equities and inequities associated with each tax, few of us would want to abandon any of these measures entirely.

In the debate over the various tax instruments, one must keep in mind the subtle differences between the "ability" and the "equal treatment" criteria. Both are equity concepts, but ability to pay is by far the more nebulous and controversial of the two. Yet ability is also the more fundamental consideration. If there is not consensus on ability to pay, we cannot possibly decide who the "equals" and "unequals" are, and the tax cannot be considered equitable. Income and wealth taxes may be preferred as better theoretical conceptualizations of ability to pay, while the equity of sales taxation derives more from its practical operation.

### Costs of Tax Administration and Compliance

If the government's costs of collecting a tax are high, less money remains to finance government services. Therefore, the generally accepted principle is that costs of collecting revenues should be as low as possible. Since compliance costs place an additional burden on the taxpayer over and above the burden of the tax itself, the taxpayer should not have to devote too much personal time or money in meeting his or her tax obligation. These concepts are quite straightforward, even though we may not often think about them.

Some taxes that fail according to other criteria, rank high on this one, and vice versa. Costs of collecting the federal cigarette tax, for example, are almost nil. (There are automatic counting machines at the factory that figure the tax continuously.) But we would hardly consider that cigarette smoking is a good measure of ability to pay! The income tax on the other hand, which is a good measure of ability to pay, ranks near the bottom on compliance and administrative costs. It is the only tax requiring substantial amounts of taxpayers' time and armies of lawyers or tax preparers and other paid specialists, not to mention the Internal Revenue Service itself. General retail sales taxes collections have very small collection costs. Owners of retail businesses act as the tax collectors. Administrative costs in connection with the property tax are somewhat higher, particularly if property is revalued

frequently, as it should be to meet equal treatment criteria. Low cost administration and compliance certainly will not be considered as important ethically as the criterion of ability to pay. But the illustration does show how one's estimation of various tax instruments can change depending on which criteria are employed.

### Certainty, Avoidance and Evasion

Since paying tax brings the payer no commensurate benefit, most people do not like to pay. For this reason paying the tax should be inevitable. The amount of tax owed by every taxpayer should be evident and unambiguous. There should be no over or under payments. This concept is called certainty. Illegal escape from a tax is called evasion. If an individual or business escapes the tax legally, it is called avoidance. By contrast, a tax where calculation of payments is open to many interpretations, or one that can be overcome easily by movement or concealment of the base, is undesirable.

All the major taxes have problems according to this criterion, though for different reasons. Income tax laws are so complex that great ambiguity arises. Corporations which operate in more than one state, for example, will try to minimize their income in a high tax jurisdiction, while maximizing income elsewhere. Unreported cash payments and the flourishing "underground economy" are factors complicating the collection of income taxes.

In the category of wealth taxation, this criterion is the only one justifying different treatment of different forms of property. Personal property taxation certainly would be used more but for the fact that movement and concealment are so easy that the tax is difficult to enforce. This same criterion justifies heavy taxation of real property. But even here the criterion of certainty is violated because of all the problems associated with property valuation.

Taxes on consumption (sales) violate this criterion too, but principally because of inter-jurisdictional differentials in tax rates. People will buy commodities in low tax jurisdictions where it is feasible for them to do so. A national sales tax levied at the source (where the commodity is produced) would fare best on this criterion.[7]

### Revenue Adequacy, Stability and Elasticity

Past experience with our multi-source revenue system clearly shows that sales and property taxes are more stable over long periods of time, whereas progressive income tax receipts rise more sharply in good economic times and fall more rapidly in bad times.

There is considerable disagreement as to whether elasticity or stability is a more desirable feature. In periods of economic prosperity, politicians usually favor elastic taxes since government services can be expanded without the necessity of raising tax rates. But, of course, this very characteristic can come back to haunt governmental policies. In bad times, demands for some government services, such as welfare and unemployment compensation, grow rapidly even as revenue receipts are falling. Balanced budgets require tax increases to service reductions in other areas of government. Stability means a steady revenue source in both good and bad economic times.

The apparent desirability of both features adds further justification to the rationale for a mixed, multi-source revenue system that can serve state and national needs under a wide variety of economic conditions.

### Taxes as an Influence on Human Behavior

Taxation is one of the most effective behavioral modification devices known.[20] People prefer to avoid taxes where possible by pursuing those activities that are lightly taxed or entirely untaxed. And for this very reason, governments require taxes that are so broadly based that people pay them almost no matter what they do. As citizens we want one thing, and as individual taxpayers we want something quite different. Indeed, this is a paradox of humanity, with which policy makers must continually wrestle.

In a democratic nation with an economy, largely based on private enterprise, such as that of the United States, the traditional presumption is that individuals should be able to dispose of their economic resources as they see fit. Taxation should not interfere with individual savings and consumption preferences. Of course, it has long been recognized that taxes inevitably must influence individual behavior in the sense that, after paying them, people's income is reduced. It is expected people will spend their remaining income in the same way they would have if they had had the same amount of money before the taxes. For example, if a business enterprise has $25,000 and is taxed $3,000, it should spend the remaining $22,000 as it would have had there been no tax at all. This principle is called tax neutrality, and theoretically, has been a guiding principle for most tax policy makers.

At the same time it has long been recognized: 1) that complete neutrality is nearly impossible to achieve; and 2) that people do not always dispose of their money in socially useful ways. Furthermore, the fact that taxes are an effective influence on human behavior is a bit of knowledge not lost on politicians. For these reasons, governments never aim at complete neutrality. The principle of some governmental influence on human behavior through the tax system is accepted by nearly everyone, though the extent and nature of this influence is controversial.

None of the major taxes are neutral. Income taxes probably encourage people to substitute leisure for remunerative work, since leisure is not taxed.[21] Wealth taxes discourage investment and capital formation and, thereby encourage consumption, while sales taxes do just the opposite. Narrowly based taxes, like selective sales, are the worst offenders in this regard. They direct consumers away from the few heavily taxed commodities to the others.

There are many cases where governments impose especially heavy taxes on doubtful human activities or encourage desirable activities through various forms of tax. For example, the higher rates of tax on distilled spirits and tobacco stem partly from the historical desire to limit their consumption. Certain deductions and credits applicable to the income tax derive from the government's desire to foster a number of activities thought to be worthwhile. Churches, schools and other eleemosynary institutions pay no property taxes for the same reason, and food is exempt from most sales taxes. A very large variety of tax provisions are designed to spur business investment and encourage capital formation. The list of various tax provisions of this sort is very long indeed. These are sometimes called "tax expenditures," and may be viewed as some sort of compromise between strict neutrality and complete government planning of the economy.

In summary, we can say that neither the principles of neutrality nor governmental direction are or ever have been fully accepted. The more realistic goal is that taxes should aim at promoting worthy activities and purposes while at the same

time allowing the private economy broad discretion to use economic resources as it sees fit.

## Tax Trends for the Late 1980s

Educational leaders not only need basic knowledge about taxation, but also a change in attitude toward tax policy. It seems clear that the present decade will be viewed as one distinctly different from the previous one in many ways, including tax policy. At the national level, concern for balanced budgets has replaced the concern for rampant inflation. At the state and local level, the electorate seems less prone now than in the last decade to pass tax or expenditure limitations. The period of Propositions 2 1/2 and 13 seems to have passed us by. This does not mean, however, that attitudes toward public sector outlays necessarily have improved. Unfortunately, large portions of the public still seem to view governmental activities with some suspicion.[24]

Within the present climate of greater concerns for balancing the federal budget and a slightly less hostile attitude toward state-local spending, five potential trends can be identified.

1. A shift of taxing responsibilities away from the federal government.
2. A "revolt" against income taxes as they are presently structured.
3. A searching for new, more acceptable tax instruments.
4. A return to use of the property tax for schools.
5. A consideration of tax credits for non-public schools.

### A Shift Away From The Federal Government

Since the election of 1980, reduction of federal expenditures has been an expressed policy goal of the Reagan administration.[25] The goal has, to mid-decade, proven to be elusive. Rates of increase in federal spending have been reduced from double digits in the inflation-ridden 1970s to single digits in the present decade. Nevertheless, federal spending increases still outpace both state and local spending growth and growth in the gross national product in most recent years.[26] Federal spending growth has been diminished, but by no means has it been halted.

One scenario for the late 1980s, then, would be a continuation of the present trend, reducing federal spending growth even further. In such a situation, state and local taxes might be expected to increase somewhat, as lower levels of government begin to assume the services formerly financed by Washington. It does not seem likely, however, that states will fund governmental services like education as fully as past federal administrations have. State and local revenue structures, which are relatively inelastic, simply will not permit it.

### A "Revolt" Against Income Taxes

Even though most professional economists still view the personal income tax

favorably, the electorate is growing increasingly hostile to it. When asked to name the "worse tax . . . that is, the least fair," about one-third of the electorate names the federal personal income tax. (Another ten percent identify their state's income tax as the "least fair" tax.) These figures are up substantially from ten years ago.

Politicians have taken this trend to mean that the electorate is calling for: 1) a reduced rate in the over-all income tax; and 2) a broadening of the tax base to eliminate certain deductions and credits now written into the law.[27]

One little discussed effect of the proposed legislation is its likely effect on states' revenue structures. Since many state income taxes are fundamentally based on the federal income tax structure, different states are likely to be affected differently by federal tax law changes. This could impact directly on state school financial aid, as states find they have shortfalls or surpluses in their treasuries.

### Tax Instruments

When asked what tax they mind least, or alternatively, what tax they would wish imposed if governments need additional revenue, people usually name the sales tax. Despite the drawbacks discussed earlier in this chapter, general retail sales taxes seem to be by far the least unpopular form of taxation.[28] And on this matter, too, the popular majority disagrees with many leading economists.

The "new" tax instrument most often discussed is the *value added tax*, a national sales tax which presumably would be levied on all purchases other than necessities such as food and drugs. Unlike the retail sales taxes with which we are familiar, the value added tax (VAT) would be levied on the producers and wholesalers as well as retailers. The tax would be embedded in the final cost of goods or services, not added to the sales price. The tax is widely used in foreign countries and, like other forms of sales tax, relatively easy to administer.[29]

At the state level one "new" and rapidly growing source of revenue is *parimutuel taxation*. Nearly every state engages in some form of tax on wagering in some form: bingo, card rooms, casinos, jai-alai, dog and horse racing, lotteries and/or off-track betting. Revenues from these sources are growing rapidly in many states, but they still make up only a small percentage of the total. Maryland is the state which relies most heavily on this revenue source, but even there, taxes raise only about five percent of the state's general revenues. In most states parimutuel taxation raises only one or two percent of revenue needs.[30]

Both the VAT and parimutuel taxation raise substantial questions according to the criteria for taxation discussed previously. For this reason their political future is much in doubt. The relatively narrow base of parimutuel taxes renders them relatively unimportant as a potential source of school support. The VAT, however, could potentially be of great help to schools.

### A Return to the Property Tax

Popular distaste for the property tax reached its peak in the early 1970s, shortly after the famous *Serrano* decision on California school financing and just before passage of Proposition 13. Popular opposition to it has diminished since then.[31]

Under one scenario, declining federal revenues for schools, plus the relatively inelastic tax structures of many states, will mean an increase in local school property taxes.[32] This almost surely would not be a welcome development for propo-

nents of fiscal equality and inter-district expenditure equalization. Property taxes have been the historic cause for school financial inequalities.

### Tax-credits for Non-public Schools

Tax credits for parents of non-public school children are another initiative proposed by the Reagan Administration, with some bipartisan support. At this writing the size of the federal budget deficit, among other considerations, makes enactment of this tax credit unlikely. The State of Minnesota, however, has enacted tax credit legislation applied to both public and private school parents and other states are considering similar measures.[13]

Effects of such initiatives on the public school revenues cannot be known. Inclusion of private schools in governmental finance measures might build support for education over-all. All families would benefit. Others argue that every dollar given to private schools, even though a tax credit, is a dollar lost to public education. Tax credits are likely to remain a contentious issue throughout the decade.

### Empirical Data

An important source of information in the development of tax policy is the extent to which states and localities actually use the various types of taxes discussed in this chapter. By far the most widely used index of actual tax utilization is developed by the Advisory Commission on Intergovernmental Relations (ACIR), an independent agency of the federal government. They measure two concepts: tax capacity and tax effort in the states. Measurements assume that each state has a "representative" tax system; that is, every state's range of tax instruments is like every other state's. The number 100 is the average for all states together. For example, in 1981 Arkansas tax capacity was 82 percent of the national average and its tax effort was 79 percent of the national average. A fuller explanation of the ACIR methodology is explained at the bottom of Table 4:9. An appropriate interpretation enables readers to compare how their state is doing relative to other states.[14]

## Summary

This chapter has dealt with different tax instruments used by all governments without detailed reference to one government. This would seem an appropriate orientation, for the tax system as a whole is the ultimate concern of public policy more than any single tax, any one public service or single level of government. We call this system as a whole the "tax structure." The term is somewhat misleading, because unlike a physical structure which is fixed and permanent, the tax structure is constantly being changed.

The discussion indicates that no tax receives a "passing grade" on all criteria. It is quite unreasonable to expect any one tax to have all the characteristics we would think appropriate for the tax structure as a whole. Each tax has unique virtues and defects. With respect to a single tax instrument then, we must impose some less demanding tests. Does it have some highly desirable features? Can its undesirable features be mitigated through the use of other tax and expenditure instruments? According to these two somewhat less stringent criteria, all the major taxes and

**Table 4:9 Representative Tax System Tax Effort Indices for 1981 and Selected Prior Years[1]**

| State | 1981 | 1980 | 1979 | 1977 | 1975 | 1967 |
|---|---|---|---|---|---|---|
| **U.S. Average** | **100** | **100** | **100** | **100** | **100** | **100** |
| New England | | | | | | |
| Connecticut | 103 | 100 | 102 | 103 | 99 | 93 |
| Maine | 113 | 111 | 110 | 100 | 104 | 105 |
| Massachusetts | 134 | 135 | 144 | 133 | 129 | 121 |
| New Hampshire | 74 | 75 | 78 | 73 | 75 | 81 |
| Rhode Island | 130 | 123 | 121 | 114 | 112 | 105 |
| Vermont | 105 | 104 | 110 | 104 | 108 | 119 |
| Mideast | | | | | | |
| Delaware | 87 | 89 | 96 | 80 | 84 | 98 |
| Dist. of Col. | 145 | 131 | 132 | 118 | 94 | 90 |
| Maryland | 107 | 109 | 109 | 105 | 106 | 103 |
| New Jersey | 112 | 112 | 118 | 113 | 103 | 97 |
| New York | 171 | 167 | 171 | 168 | 160 | 138 |
| Pennsylvania | 105 | 104 | 105 | 94 | 93 | 99 |
| Great Lakes | | | | | | |
| Illinois | 105 | 102 | 99 | 96 | 99 | 84 |
| Indiana | 88 | 84 | 84 | 83 | 92 | 95 |
| Michigan | 116 | 116 | 113 | 109 | 106 | 100 |
| Ohio | 89 | 87 | 86 | 78 | 80 | 82 |
| Wisconsin | 120 | 116 | 118 | 113 | 115 | 124 |
| Plains | | | | | | |
| Iowa | 98 | 96 | 93 | 90 | 93 | 104 |
| Kansas | 87 | 88 | 87 | 89 | 85 | 96 |
| Minnesota | 109 | 111 | 115 | 112 | 117 | 119 |
| Missouri | 81 | 84 | 82 | 80 | 84 | 86 |
| Nebraska | 95 | 102 | 98 | 98 | 85 | 78 |
| North Dakota | 74 | 79 | 78 | 88 | 92 | 97 |
| South Dakota | 93 | 88 | 84 | 87 | 87 | 107 |
| Southeast | | | | | | |
| Alabama | 91 | 85 | 86 | 79 | 79 | 89 |
| Arkansas | 79 | 86 | 81 | 78 | 78 | 83 |
| Florida | 73 | 74 | 78 | 73 | 74 | 84 |
| Georgia | 97 | 96 | 96 | 89 | 89 | 92 |
| Kentucky | 88 | 89 | 87 | 84 | 84 | 85 |
| Louisiana | 77 | 78 | 82 | 79 | 87 | 90 |
| Mississippi | 95 | 96 | 97 | 94 | 96 | 98 |
| North Carolina | 95 | 97 | 91 | 87 | 86 | 94 |
| South Carolina | 95 | 95 | 91 | 86 | 85 | 97 |
| Tennessee | 87 | 84 | 87 | 82 | 79 | 87 |
| Virginia | 90 | 88 | 88 | 88 | 87 | 90 |
| West Virginia | 83 | 82 | 82 | 80 | 85 | 96 |
| Southwest | | | | | | |
| Arizona | 106 | 117 | 115 | 110 | 108 | 109 |
| New Mexico | 89 | 83 | 85 | 77 | 85 | 92 |
| Oklahoma | 73 | 72 | 74 | 72 | 73 | 80 |
| Texas | 65 | 65 | 64 | 68 | 68 | 75 |
| Rocky Mountain | | | | | | |
| Colorado | 84 | 90 | 96 | 95 | 90 | 106 |
| Idaho | 87 | 88 | 90 | 89 | 90 | 105 |
| Montana | 92 | 92 | 88 | 94 | 92 | 93 |
| Utah | 97 | 101 | 99 | 91 | 89 | 111 |
| Wyoming | 73 | 74 | 83 | 82 | 70 | 79 |
| Far West | | | | | | |
| California | 100 | 102 | 95 | 117 | 119 | 108 |
| Nevada | 62 | 60 | 65 | 62 | 70 | 71 |
| Oregon | 101 | 93 | 93 | 92 | 96 | 101 |
| Washington | 92 | 94 | 96 | 94 | 101 | 106 |
| Alaska | 184 | 166 | 129 | 130 | 76 | 104 |
| Hawaii | 126 | 124 | 128 | 115 | 119 | 135 |

1/ Personal income based index of tax effort is formulated by first dividing each state's and local taxes by state personal income, and then indexing each result to the average for all states (i.e., national total of state-local taxes divided by national personal income). 100 becomes the index for the U.S. average.

Source: U.S. Advisory Commission on Intergovernmental Relations, *1981 Tax Capacity of the Fifty States*, A-93 (Washington, D.C.: U.S. Government Printing Office, 1983), Table 6, p. 12.

most of the minor ones now in use are acceptable, although the relative reliance on each can be debated.

The political controversy over taxes can be viewed as a debate over the relative importance of the criteria discussed. For example, those who think ability to pay is more important than certainty and avoidance may favor income or wealth taxes. Equal treatment of people in the same circumstances may argue for sales taxes, and so on. Political judgments as to the relative importance of the criteria will change with the passage of time. But the criteria themselves are likely to remain with us in the future as they have in the past.

Over the years we have noted substantial shifts in tax structure. States collect a greater proportion of all taxes than they used to, and the states' share may grow even further due to federal fiscal retrenchment. Income taxes have become by far the leading tax instrument; there is now serious questions about the fairness of the burden and the efficient administration of this tax instrument. Likewise, intergovernmental revenue transfers have grown greatly, divorcing to some extent the taxing functions of government from the spending function.

There are other more recently emerging trends that relate as much to the magnitude of the total tax burden as to reliance on any particular tax. Federal income tax rates have been reduced recently, even as revenues have grown. At the federal level, government deficits continue to be a concern, and proposals are made for amendments to the Constitution that would require a balanced national budget. These new emphases suggest that political and social priorities have emerged toward the end of the last decade which will continue to shape tax policy through the present decade.

In such a political and economic climate it is highly unlikely that school finance can remain on its own, isolated from broader economic events. In the future, education's prosperity is likely to depend, to some extent, on the prosperity of the broader economy. If so, then education may no longer be called a "growth industry" but a "cyclical industry" that depends for its success on an over-all healthy economy.

The present period then presents challenges to school business administrators and other educational leaders, forcing them to obtain new knowledge and skills beyond those that sustained the profession in the past. Simply mastering the technicalities of school funding and budgeting will not be enough. Understanding the broader economic trends and concepts will be essential for administrative planning, influencing policy making and managing schools in the future.

## Notes

1. Adapted from Chapter 3 in *Introduction to School Finance*, by Thomas H. Jones, Jr., Copyright © 1985 by Thomas Jones, Jr. Used with permission of Macmillan Publishing Company, New York, a Division of Macmillan, Inc.

2. For further discussion in basic texts see L.L. Ecker-Racz, *Its Your Business: Local and State Finance* (New York: National Municipal League, 1976); J.A. Maxwell and J.R. Aronson, *Financing State and Local Governments* (Washington, DC: Brookings, 1976); E.K. and J.M. Browning, *Public Finance and the Price System* (New York: Macmillan, 1983). A recent empirical examination of the entire, federal-state-local tax structure appears in D. Phares' "The Interstate Distribution of Federal State and Local Tax Burdens in the United States," *Journal of Education Finance*, 9 (Spring, 1984), 407-439.

3. R. Guenther, "California Tax Cuts Have Led to Higher New-Home Prices," *The Wall Street Journal* (March 17, 1982), 29.

4. Famous proponents of this view were the English socialists Beatrice and Sydney Webb, see e.g., *National Finance and a Levy on Capital: What the Labour Party Intends* (Westminster: The Fabian Society, 1919). Economists today often reject this view that tax systems can measure the psychological dispositions of people. Equity concepts form the basis for progressive taxes today.

5. See e.g., J.A. Pechman, *Options For Tax Reform* (Washington, DC: Brookings, 1984).

6. For example, the personal exemptions for couples filing a joint state income tax return were $9,000 in Louisiana and $9,500 in Mississippi in 1983. Other states, such as Connecticut, tax only the income derived from a narrower base such as interest and dividends. See Advisory Commission on Intergovernmental Relations *Significant Features of Fiscal Federalism, 1982-83 Edition* (Washington, D.C: Advisory Commission on Intergovernmental Relations, 1984).

7. This artifact of a progressive rate structure becomes clear through an example. Suppose there is one taxpayer paying at 50 percent rate and a second lower income taxpayer at 30 percent. Both have the same deduction, say, $100. The first taxpayer saves $50 from his tax bill, $100 x 50% = $50; the poorer taxpayer saves on $30, 100 x 30% = $30. If the $100 item had been a credit instead of a deduction, both persons would have payed a full $100 less in tax. Of course the government also would have given up $200 in revenue rather than only $80.

8. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1979-80 Edition* (Washington: Advisory Commission on Intergovernmental Relations, 1981), 95, 131.

9. For a more detailed summary of the controversy plus copious references to the scholarly literature see J.A. Pechman and B.A. Okner, *Who Bears the Tax Burden?* (Washington: Brookings, 1974), 24-43.

10. Ibid.

11. C.S. Shoup, *Public Finance* (Chicago: Aldine, 1969).

12. *Significant Features*, ACIR.

13. W.V. Grant and T.D. Snyder, eds. *Digest of Educational Statistics, 1983-84* (Washington DC: National Center for Educational Statistics, U.S. Government Printing Office, 1983), 27, 78.

14. New York Assembly Task Force on School Finance and Real Property Classification, *The Legislative Response to the Property Tax Crisis* (Albany: The Capitol, 1979), 9.

15. R.C. Wood, *Property Assessment Practices for School Tax Purposes* (Reston, VA: Association of School Business Officials, 1985); R.C. Wood, "An Update on 1982 Real Property Tax Practices for Financing Public Elementary and Secondary Education," *Journal of Education Finance*, 9 (Spring, 1984), 524-528.

16. *Significant Features*, (ACIR).

17. Both views are discussed in H.J. Aaron, *Who Pays the Property Tax? A New View* (Washington DC: Brookings, 1975).

18. This issue receives extended treatment in J. Coons, W. Clune and S. Sugarman, *Private Wealth and Public Education* (Cambridge: Belknap Press, Harvard University, 1970).

19. C.S. Benson, *The Fleischmann Report on the Quality Cost and Financing of Elementary and Secondary Education in New York State* (New York: Viking, 1973).

20. For a discussion of the issues surrounding ability to pay and equal treatment for the federal income tax see J.A. Pechman, *A Citizen's Guide to the New Tax Reform* (Totowa, NJ: Rowman and Allanheld Pub. Co., 1985).

21. H.J. Aaron, ed., *The Value-Added Tax: Lessons from Europe* (Washington DC: Brookings, 1981).

22. H.J. Aaron and J.A. Pechman, *How Taxes Affect Economic Behavior* (Washington DC: Brookings, 1981).

23. The other view is that income taxes encourage work, since people's disposable income is lowered by the amount of the tax. Certainly this view is correct for those people who want additional income more than added leisure time. But the income tax is still not neutral even under the alternative interpretation.

24. For a more detailed discussion see, R.J. Dworak, *Taxpayers, Taxes and Government Spending Perspectives on the Taxpayer Revolt* (New York: Praeger, 1980).

25. See e.g., *The Economic Report of the President* (Washington DC: U.S. Gov. Printing Office, 1984), 7-9.

26. *Significant Features*, (ACIR).

27. Pechman, *A Citizen's Guide*.

28. *Significant Features*, (ACIR) 91.

29. Aaron, *Value-Added Tax*.

30. *Significant Features*, (ACIR).

31. Ibid.

32. J. Augenblick, "The Importance of Property Taxes to the Future of School Finance," *Journal of Education Finance*, 9 (Winter, 1984), 384-393.

33. For a more detailed discussion of this issue see R. McCarthy and J. Skillen, *Disestablishment a Second Time: Genuine Pluralism for American Schools* (Grand Rapids, MI: Eerdmans Pub. Co.).

34. Wood, "An Update on 1982 Real Property Tax Practices."

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